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MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-463

CHESTNUTT MANAGEMENT CORPORATION,

Petitioner,

v.

ELEANOR C. MILLER,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

**RESPONDENT'S BRIEF IN OPPOSITION TO
THE PETITION FOR A WRIT OF CERTIORARI**

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PRELIMINARY STATEMENT

The respondent, Eleanor C. Miller ("Mrs. Miller") respectfully requests that this Court deny the petition of Chestnutt Management Corporation ("Chestnutt"), for a writ of certiorari to the United States Court of Appeals for the Second Circuit to review a judgment entered on April 3, 1978. That court, without a report-

ed opinion, affirmed from the bench the judgment of the District Court of Connecticut entered following a jury verdict for the respondent in the amount of \$53,000, and the District Court's order denying the petitioner's motion for judgment n.o.v. or in the alternative for a new trial.

JURISDICTION

The jurisdictional requisites are adequately set forth in the Petition at page 2.

QUESTIONS PRESENTED

The questions presented by the Petitioner are reducible to the following:

1. Were the District Court and Court of Appeals correct in holding there was sufficient evidence upon which a jury could find the petitioner liable to the respondent on either the claim of (1) violation of the Investment Advisers Act of 1940, or (2) common law fraud?

2. Does a finding of fraud under Section 206 of the Investment Advisers Act of 1940, and SEC Rule 206(4)-1, thereunder, prohibiting deceptive and fraudulent acts and practices of investment advisers, infringe the First Amendment freedoms of the petitioner?

3. Does a private right of action exist to remedy violations of Section 206 of the Investment Advisers Act of 1940?

STATUTE AND REGULATION INVOLVED

Sections 206 and 214 of the Investment Advisers Act of 1940, 15 U.S.C. §§80b-6, 80b-14 and SEC Rule 206(4)-1, 17 C.F.R. §275.206(4)-1 (1976) are set forth in the appendix to the Petition at A26 through A30.*

* Numerical references preceded by A indicate pages of the Appendix to the Petition.

STATEMENT OF THE CASE

Material Facts

Mrs. Miller, a former nurse, authorized her husband, Dudley Miller ("Miller"), to act on her behalf with respect to her investment portfolio. Miller, at the time of the incidents involved in this action was an attorney with an oil company, stationed in Tripoli, Libya. Chestnutt, a wholly owned subsidiary of Chestnutt Corporation, is engaged in the business of managing private investment portfolios, and is registered under the Investment Advisers Act of 1940.

Miller, being in Africa, felt that his wife's portfolio required direct and constant supervision in the United States; hence, in May, 1968, during a short stay in the United States, he visited Chestnutt's offices in Greenwich, Connecticut. During this visit, Miller was shown certain ledgers illustrating the history of selected investment accounts then under Chestnutt management, all of which evidenced very substantial earnings and gains. Miller also received a guided tour of the Chestnutt facilities and was shown the complicated charts and graphs allegedly used in the Chestnutt operation.

In his discussions with Chestnutt representatives Miller specifically pointed out the difficulties his overseas location presented in obtaining sufficient information to supervise his wife's investments and that, in any case, he was no expert in the market. He explained his rather basic investment concerns and policies, among them an expectation that securities would be sold to cut losses when they acted contrary to expectations and that short selling was a tactic to be employed in weak stock markets. Miller was given every reason to believe that Chestnutt was qualified and prepared to handle the account in the manner discussed.

At the conclusion of his visit Miller was given a 48 page booklet written by George A. Chestnutt, President of Chestnutt Corporation, entitled *Stock Market Analysis Facts and Principles*. This booklet, referred to at trial as the "red book", emphasized in detail the uses and benefits of various stock market charts and averages including Chestnutt Corporation's 800 stock Geometric Average. Aided by a multiplicity of charts and graphs, the red book discussed with apparent authority such concepts as "Divergent Trends", "Percentage Strength Ratings", and "Ratio Analysis". On the back cover, the booklet added a signed statement by George A. Chestnutt, as follows:

The most up-to-date source of information for market forecasting is obtained from the action of the stock market itself.

Upon his return to Libya, Miller received numerous communications from Robert A. Whitman, a vice president of Chestnutt responsible for soliciting new clients, with the stated purpose of motivating Miller to engage the services of Chestnutt. These communications contained glowing descriptions of Chestnutt's investment management record, another copy of the red book, and a reprint from an article about George A. Chestnutt's investment theories which appeared in the magazine *Medical Economics*. (A1-A7).

When it became apparent that he would be overseas for the foreseeable future, Miller transferred the management of Mrs. Miller's portfolio to Chestnutt under a fee arrangement. Miller had read the red book and relied on it and on other statements by Chestnutt personnel in opening the account and with respect to how the account would be managed. The portfolio, on February 28, 1969, the opening date under Chestnutt management, was valued at \$131,305.12, 26% of which was in cash.

Thereafter Miller began to receive by mail on a weekly basis two Chestnutt publications: *Stock Market Survey*, and *Stock Selection Guide*. Each *Survey* contained a reading from an index called the "Trend Oscillograph", a market timing indicator claimed to be "unique" to Chestnutt. The Trend Oscillograph, heavily relied upon by Chestnutt portfolio managers, was described by Warren K. Greene, President of Chestnutt, as a device by which one could determine whether the market was likely to go up or go down. The *Stock Selection Guide* gave "Percentage-Strength Ratings" to individual stocks. Each stock in Chestnutt's 800 stock Geometric Average was assigned a rating from 0 (the lowest) to 99 (the highest). These ratings were developed, in Greene's words, by George A. Chestnutt through the means of a "very complicated computer formula" and were designed to "give us some facts on which to go on". In discussing these ratings in the red book George A. Chestnutt wrote:

All we need to know to act profitably is *which stocks are relatively strongest and which stocks are relatively weakest*. Percentage-Strength Ratings provide this information. [emphasis in original].

None of Chestnutt's charts, graphs, ratings or indices contained any disclosure, prominent or otherwise, of their limitations or the difficulties with respect to their use.

Throughout the period Mrs. Miller's account was managed by Chestnutt, the *Survey* exuded unreserved optimism over stock market conditions. With two exceptions, for thirty-six consecutive weeks from July 31, 1969 to April 9, 1970, the *Survey* began its commentary with these precise words: "the general market trend

evidence continues bullish."* Moreover, from June 26, 1969 through April, 1970, the Trend Oscillograph registered plus or "bullish" and from January, 1970 showed extremely "bullish" figures.**

In contrast to this emphatically optimistic description of the stock market which was regularly being sent overseas each week to the Millers, the stock market itself was in the midst of a major and continuing decline, and the value of the Miller stock portfolio in the hands of Chestnutt was dwindling with alarming speed.

Both the stock market averages themselves and expert testimony clearly evidenced that the market was on a steep down-trend from November, 1969 on. Chestnutt's own Geometric Average fell 22% between December, 1969 and April, 1970. In this period the Miller account remained nearly fully invested in securities and contained several securities which held Chestnutt's own Percentage Strength Ratings of less than 10, despite Chestnutt's published warning to sell any security rated under 20.

The resulting effects on the Miller portfolio were disastrous. On May 31, 1969 the account value stood at \$139,361.69. By November 30 it was \$97,787.82, and on February 28, 1970 the value had fallen further to \$83,027.80. On April 24, 1970, when Miller terminated the services of Chestnutt, the value of the account was \$56,501.95, a decrease of \$82,859.74 or 60% in less than eleven months.

* The October 9, 1969 *Survey* stated there was little change in the trend evidence which had been described as "bullish" in the preceding nine weeks. On February 5, 1970 the market was described as "oversold".

** The Trend Oscillograph was said to be capable of readings from "plus 30" (the most favorable or "bullish") to "minus 30" (the least favorable or "bearish").

Chestnutt well knew that Miller's only way to keep abreast of stock market conditions while in Libya was through the weekly Chestnutt *Survey* and *Guide*. When Miller received an account statement as of August 31, 1969 showing approximately a \$20,000 decline in the portfolio value, he wrote of his anxiety to Lewis Katcher, the Chestnutt portfolio manager. Miller learned of a further substantial decline at the end of November and, on one of his infrequent trips to the United States, spoke to Katcher over the telephone of his concern that Katcher and Chestnutt did not know how to get out of a losing stock, saying: "I think it [a stock] has to drop off your chart before you sell it". At that point Katcher informed Miller for the first time that Chestnutt was rated "D minus" in a falling market.*

Miller went on to say: "we should get out [from under Chestnutt], that they were doing such a bad job", but Katcher "pleaded with me to stay, [saying] I finally have the portfolio in such a condition that I am ready for the turn-around". Katcher further stated: "Mr. Chestnutt has predicted the last three turn-arounds." Based on this conversation with Katcher, Miller decided to maintain the portfolio with Chestnutt, and returned to Libya about January 1, 1970.

The actual status of the account and its management belied Katcher's assurances. Within two months of his description that the account was "ready for the turn-around", ten securities in the account (over half the portfolio) were sold, and six new securities purchased. Only two of these purchased securities were even included in the 800 stocks accorded ratings by Chestnutt, and all, when later sold, resulted in substantial losses.

* This was a rating accorded investment managers by *Forbes* magazine. D minus was the lowest possible rating.

Upon receipt of the statement of account as of February 28, 1970, showing a further substantial decline in value, Miller wrote an angry letter to Whitman, who attempted to explain the situation in a lengthy letter dated April 3, 1970, stating: "... we have done a poor job ... [not only because of the market conditions but because] our firm has definitely not been able to coordinate its thinking properly with the market climate as it prevailed up to this point". Whitman's reply continued by repeating the statement that Mrs. Miller's account was in good shape for the next upward movement, and in ironic contrast to the glowing assurances and solicitation materials Miller had received, stated:

Being located as remotely from our office as you happen to be, you certainly have not had the best point of vantage to understand both the weaknesses and the strengths that prevail in our organization.

Whitman then stated that had Miller been able to examine the Chestnutt record he would have noted the "average to rather poor performance" of Chestnutt in other than sustained bull market conditions. In summation, Whitman asked Miller "to look upon our organization's bull market strength with the hope that we can develop a marvelous recovery for Mrs. Miller's account".

While the account supposedly remained primed for the bull market, the bear market continued and on April 24, 1970 Miller terminated Chestnutt's services by cable, ordering the account sold out.

Proceedings Below and the Decision of the Court of Appeals

Respondent filed suit in 1972 and, after a three-day trial, the case was submitted to the jury on two claims: that the petitioner had violated the provisions of Section 206 of the Investment Advisers Act of 1940 including SEC Rule 206(4)-1, and that the petitioner had committed fraud at common law. The jury returned a general verdict in favor of Mrs. Miller. Senior District Judge Thomas F. Murphy subsequently denied Chestnutt's motion for judgment n.o.v. or for a new trial. (A18).

The Court of Appeals for the Second Circuit affirmed the District Court's judgment in a decision rendered from the bench after oral argument and, pursuant to its practice,* issued a short oral statement. (A23-A25). In affirming, the Court's statement noted a few of the reasons upon which, among others, it relied. First, it concluded that from the evidence presented a jury could have found a violation of SEC Rule 206(4)-1(a)(3) because of Chestnutt's lack of disclosure of the limitations of its system of graphs and tables and the Trend Oscillograph. Moreover, Judge Timbers stated, "Chestnutt's intentional failure to disclose its prior performance in bear markets we hold constituted a sufficiently material non-disclosure to support a jury finding of common law fraud." (A24). With respect to the challenged charge to the jury, there was nothing in the charge to warrant reversal, as is more fully discussed below.

Following the decision of the Second Circuit, Chestnutt sought a rehearing and suggested consideration by the Court *en banc*. The petition was denied, and no active judge or judge who sat on the original panel requested that a vote be taken on the suggestion.

* Rules of the United States Court of Appeals for the Second Circuit, §0.23

ARGUMENT

The Petition fails to raise any issues warranting review by the Supreme Court. One District Judge and three judges of the Second Circuit have passed on and found against the petitioner on the question of the sufficiency of the evidence. The Court of Appeals decision is not in conflict with any decisions of this Court or those of any other circuit. The claim of an infringement of First Amendment freedoms is without merit.

POINT I

THE JURY HAD SUFFICIENT EVIDENCE TO SUPPORT A GENERAL VERDICT THAT CHESTNUTT VIOLATED THE PROVISIONS OF SECTION 206 OF THE INVESTMENT ADVISERS ACT OF 1940 OR COMMITTED FRAUD AT COMMON LAW

The record discloses, and the District Court and Court of Appeals held, that there was sufficient evidence to support a jury verdict of both a violation of the Investment Advisers Act and common law fraud. Respondent submits that on this record further review of the evidence by the Court is not warranted; nevertheless, a summary of the frauds perpetrated upon the Millers by Chestnutt follows, as well as comment on the charge to the jury.

A. There was Ample Evidence of Common Law Fraud and Violations of the Investment Advisers Act

Subsections (1) and (2) of Section 206 of the Investment Advisers Act make it unlawful for an investment adviser "to employ any device, scheme, or artifice to defraud any client," and "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client". In addition, under authority granted by Subsection (4) of

Section 206, the SEC has promulgated Rule 206(4)-1 defining and prescribing means to prevent fraudulent or deceptive practices by investment advisers. From the very outset Miller was exposed to the practices of Chestnutt which were to operate as frauds on his wife in the handling of her account. Through solicitation materials and personal contact Chestnutt led Miller to believe that it was eminently equipped to manage the account under all market conditions in accordance with policies he asked to be pursued and in accordance with what could reasonably be expected of a prudent investment adviser.

1. Chestnutt, however, intentionally failed to disclose to Miller prior to the transfer of the account that, in fact, its investment performance in a falling stock market was poor and had received the lowest rating given by *Forbes* magazine. As noted above, the Second Circuit held this non-disclosure sufficient in itself to support a jury finding of common law fraud.

2. Miller was not informed that Chestnutt's philosophy of investment management was geared solely to capitalizing on a general upswing in the stock market. Such a limited management philosophy alone was of such material import to the Millers that its non-disclosure under any interpretation of fiduciary responsibility was misleading and a fraud, both at common law and by statute. The evidence of this limited strategy was more than sufficient for the jury finding. Only one short sale was executed and that occurred before the market decline accelerated. George A. Chestnutt at trial, contrary to his representations in the "red book", admitted that short selling was not a major element of his approach. Equally damaging was the admission by Chestnutt's vice president, thirteen months after Chestnutt had taken over the investment account, that Miller had not been given the information needed to understand the weaknesses and strengths of the Chestnutt organization, particu-

larly its weaknesses in other than "sustained bull markets". These frauds were accented by the portfolio manager's repeated assurances to Miller that the portfolio was ready for the "turnaround".

3. Chestnutt failed to observe the most elemental fiduciary responsibilities of a paid investment adviser. It emphasized in its solicitation materials the importance of the information and "facts" contained in its 'Percentage Strength Ratings' and then ignored these very ratings in the management of the Miller account which contained numerous securities assigned the lowest ratings, and it categorized the market trend evidence as "bullish" in complete disregard of the contrary trend of the stock market. Chestnutt had full knowledge of Miller's location in Africa and his reliance on the Chestnutt stock ratings and reports of market conditions.

4. The solicitation materials also described the desirability and indeed requirement to sell short and cut losses in weak securities. Nevertheless, Chestnutt continually held onto weak securities over long periods at substantial losses to the Miller account.

5. Miller was plainly deceived by the representations of Katcher in December of 1969, designed to keep the account with Chestnutt, that, despite losses, the account was in shape for the turn-around. The evidence of transactions in the account almost immediately thereafter showed clearly that Katcher's statement was knowingly false when made and operated as a deceit and a fraud upon the Millers.

6. Chestnutt's systems of graphs and tables and its Trend Oscillograph, lacking adequate disclosure of their limitations, were direct violations of the provisions of SEC Rule 206(4)-1(a)(3), as the Court of Appeals specifically held.

7. The *Medical Economics* article (A1-A7), reprinted

and distributed to potential clients at Chestnutt's expense, was a "testimonial" to Chestnutt within the meaning of SEC Rule 206(4)-1(a)(1), the dissemination of which acted as a fraud and deception.

Based on the foregoing record, it is submitted that the jury had abundant evidence of Chestnutt's frauds against Mrs. Miller.

B. The Court of Appeals Examined the Entire Trial Record and Applied Settled Principles of Law.

The brief oral statement of the Second Circuit panel on appeal rejected Chestnutt's argument, now repeated in the Petition, about the adequacy of the charge to the jury.* The charge as a whole was considered "in the context of the entire record" and the Court of Appeals only commented on the District Judge's use of the word "negligently" disjunctively with the words "fraudulently" and "recklessly" as an element of common law fraud. The Court of Appeals held that this part of the charge did not require reversal for the reason that *scienter*, if required at all, is imputed where a negligent representation is made in the context of a violation of a duty of care. This holding was in full accord with the Connecticut law of fraud.

A delicate fiduciary relationship exists between investment adviser and client. *SEC v. Capital Gains Research Bureau, Inc.* 375 U.S. 180, 191 (1963); *Galfand v. Chestnutt Corp.* 545 F.2d 807, 811 (2d Cir. 1976) *cert. denied*, — U.S. —, 98 S.Ct. 1524 (1978). This relationship imposes a duty of reasonable care to avoid misleading clients. As stated in *SEC v. Capital Gains Research Bureau, Inc., supra*:

* Judge Van Graafeiland, in a concurring statement, correctly noted that petitioner had failed to meet the requirements of Rule 51, *Fed. R. Civ. P.* by not objecting to the charge. The holding of the Court of Appeals was on the assumption "for present purposes that objections to the charge were properly preserved in the district court . . ." (A25).

Courts have imposed on a fiduciary . . . an affirmative obligation "to employ reasonable care to avoid misleading" his clients. There has also been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue. 375 U.S. at 194 [footnotes omitted].

Where the duty to disclose exists, the intentional non-disclosure of all the facts is actionable misrepresentation, *Franchey v. Hannes*, 152 Conn. 372, 207 A.2d 268 (1964), and the recipient of representations in a fiduciary context may be justified in relying on opinions on the basis that the maker has undertaken the investigation of the underlying facts. *Warman v. Delaney*, 148 Conn. 469, 172 A.2d 188 (1961); *Day v. Avery*, 548 F.2d 1018 (D.C. Cir. 1976) *cert. denied* 431 U.S. 908 (1977).

The Petition, in essence, asks this Court to make a third review of the trial record in the hope that it will conclude that the findings of a jury and four federal judges with regard to the weight and sufficiency of the evidence were wrong. Such further canvassing of the record would serve no interests outside those of the petitioner and is a task ill fit for the granting of a writ of certiorari.

POINT II

RESPONDENT HAS NOT RAISED A FIRST AMENDMENT ISSUE MERITING REVIEW

The Petition addresses an alleged issue of an impairment of First Amendment rights. Such a suggestion was raised for the first time tangentially in petitioner's reply brief before the Second Circuit. The

claimed issue was not deemed to merit discussion below, and nothing in the Petition warrants this Court's review. It is noted that the Petition does not include a statement pursuant to the provisions of Supreme Court Rule 33(2)(b).

Commercial speech, while accorded limited protection under the First Amendment, *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council*, 425 U.S. 748 (1976), is nevertheless subject to regulation. In *Virginia Pharmacy* this Court stated: "The First Amendment...does not prohibit the State from insuring that the stream of commercial information flow cleanly as well as freely", *id.*, at 771-2; and found "no obstacle" to regulations of deceptive or misleading commercial speech, pointing specifically to the appropriateness of requirements of disclaimers or warnings to prevent deception. *Id.*, at 771 and n. 24.

Justice Stevens' opinion in *Young v. American Mini Theatres, Inc.*, 427 U.S. 50, 68 (1976) pointed out: "... regulatory commissions may prohibit businessmen from making statements which, though literally true, are potentially deceptive", citing *Jacob Siegel Co. v. FTC*, 327 U.S. 608 (1946) as evidence of long recognition of the Government's power to restrain misleading as well as false statements in labels and advertisements.

Most recently *Bates v. State Bar of Arizona*, 433 U.S. 350 (1977), stated:

. . . [A]dvertising that is false, deceptive, or misleading of course is subject to restraint. (citation omitted). Since the advertiser knows his product and has a commercial interest in its dissemination, we have little worry that regulation to assure truthfulness will discourage protected speech....Indeed, the public and private benefits from commercial speech derive from confidence in its accuracy and reliability. Thus, the leeway for untruthful or

misleading expression that has been allowed in other contexts has little force in the commercial arena." *Id.*, 97 S.Ct. 2691, 2708-09.

First National Bank of Boston v. Bellotti, —U.S.—, 98 S.Ct. 1407 (1978) cited by petitioner does not support its arguments. The question presented there was not whether corporations have First Amendment rights, but whether legislation prohibiting corporate expenditures made to influence an individual income tax referendum abridged the type of expression meant to be protected by the First Amendment. *Id.* 1415. *Bellotti* turned on the type of speech involved (described as "intimately related to the process of governing", *id.* 1421) and does not alter the conclusions quoted above regarding the propriety of regulating misleading or deceptive expression.

Petitioner would have this Court view the decision below as a direct infringement of the right to publish a "red book" or financial opinion. This case, however, does not affect the right to publish or express views; very simply, it involves the obligations of Chestnutt, having sought and induced reliance by means of such expression, to act in a way which is not misleading or deceitful.

Despite petitioner's protestations, this is a civil action for damages for fraud, not a case of indictment or attainder (*cf* Petition, pp. 4 and 11). The Court of Appeals correctly ignored petitioner's belated argument that the First Amendment insulates a paid investment adviser from its fiduciary responsibilities not to practice frauds and deceptions upon clients.

POINT III

A PRIVATE RIGHT OF ACTION MAY PROPERLY BE IMPLIED TO REMEDY VIOLATIONS OF SECTION 206 OF THE INVESTMENT ADVISERS ACT OF 1940

Three courts of appeals in recently reported decisions have recognized a private right of action under Section 206 of the Investment Advisers Act.* There are no court of appeals decisions to the contrary, to respondent's knowledge. This Court has recently denied certiorari in *Abrahamson v. Fleschner* and petitions for a writ of certiorari are pending in *Wilson* and *Lewis* cited in the footnote.

In *Abrahamson*, Judge Timbers, writing for a majority of the Second Circuit panel, carefully elucidated the rationale for implying such a right of action and based the court's analysis on the controlling principles set forth by this Court in *Cort v. Ash*, 422 U.S. 66 (1975). A similarly careful analysis employing the *Cort v. Ash* criteria was carried out in the majority opinion of the Fifth Circuit in *Wilson*, and most recently, the Ninth Circuit in *Lewis* has expressly adopted these rationales.

These decisions are in full accord with the thrust of this Court's general recognition in *Cort v. Ash* and specific statement in *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) that private enforcement of federal rights are often a necessary supplement to effective federal regulation. The decisions of the three courts of appeals are the reasoned product of over a generation's experience with the federal securities laws and are

* *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977) cert. denied —U.S.—, 98 S.Ct. 2253 (1978); *Wilson v. First Houston Investment Corp.*, 566 F.2d 1235 (5th Cir.), petition for cert. filed, 47 U.S.L.W. 3019 (U.S. June 1, 1978) (No. 77-1717); *Lewis v. Transamerica Corp.*, 575 F.2d 237 (9th Cir.), petition for cert. filed, 47 U.S.L.W. 3019 (U.S. May 5, 1978) (No. 77-1645)

consistent with the decisions of this Court finding implied rights of action. The Petition fails to present compelling reasons for this Court to grant certiorari.

CONCLUSION

**FOR THE FOREGOING REASONS, THE PETITION
FOR A WRIT OF CERTIORARI SHOULD BE DENIED.**

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